

Garnault Review: Submission on Issue Paper 2

Financial Services for Managing Risk: Climate Change and Carbon Trading

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Introduction

Australia has recognised in the Garnault Review that a very significant scaling up of carbon finance is required to deliver the low-carbon technologies necessary over a time-frame that can limit the adverse impacts of climate change. The United Nations Framework Convention on Climate Change (UNFCCC 2007) estimates that 86% of the incremental investment and financial flows of around \$200 billion per year required by 2030 will need to come from the private sector. While the scale of capital required does not appear to be a barrier, the WBCSD (2007) suggests that the real challenge is directing capital towards the development, demonstration, and deployment of low-carbon technologies. The private sector mobilises capital best when there are unambiguous market signals such as can be achieved through an emissions trading system providing spot and future prices for carbon emissions.

Global investment banks such as Merrill Lynch have been among the biggest liquidity providers to participants in the emissions markets and have developed a series of carbon finance solutions for industry, institutional, hedge fund, and individual investor clients built on the foundation of a deep and liquid emissions market. Merrill Lynch has, for example, traded more than 450 million tonnes of CO₂e in the EU ETS thus far and is one of the biggest traders in the relatively new (and primarily OTC) options market for emissions. Below, we provide our commentary on some of the questions raised in Issues Paper 2 and provide a set of additional observations.

Question: Is permit price realisation and discovery best facilitated through the use of auctioning under an ETS?

The Australian government should consider a hybrid approach to distributing allowances, with at least 25% auctioning at the outset gradually ramping up to a larger proportion. Much has been made by commentators about the ability of power generators to pass on the opportunity costs of the EUA in some electricity markets such as occurred in parts of the EU during the EU ETS Phase I. Because the allowances were received for free, this resulted in accusations from some quarters of windfall profits. In fact, it can be argued that the increased electricity costs now faced by the broader EU industry, commercial, and residential has now led to a growing sensitivity of the importance of energy efficiency resulting in behavioural change and increased general awareness about climate change. One means of addressing the potential for windfall profits in the Australian power sector is to have an increasing proportion of allowances being distributed via auctioning as opposed to grandfathering for free. The size and frequency of allowances auctions should be chosen to minimise their impact on secondary wholesale emissions markets. Some harmonisation with other ETS would be warranted to minimise international competitive distortion. Auctioning will play an ever more prominent role in allowance distribution in Phase 3 of the EU ETS and features prominently in the proposed US national cap-and-trade bills (e.g. Lieberman-Warner bill S.2191 includes 25% auctioning from its first year.)

Question: What features of an ETS might impede the emergence of forward markets?

An anathema to forward markets would be inclusion of a price cap in the proposed Australian ETS. Some countries have proposed price caps for their domestic emissions trading schemes as a means of cost control. In practice such price caps, if set at too low a level, can act as a carbon tax and providing little incentive for innovation. Moreover, if schemes are linked, the price cap would effectively be transferred through to the other schemes thereby affecting the incentive for emissions reductions in the linked schemes. Price caps greatly reduce the incentive for financial intermediaries to provide risk management and liquidity services.

One sign of the health and growing maturity in the carbon emissions markets during 2007 has been the increase in the use of derivatives (futures and options contracts) to increase liquidity and provide additional risk management services for participants in the market. Such instruments were largely absent during the first phase of the EU Emissions Trading Scheme but are now increasingly used to hedge participants' financial risks in the market for 2008-2012. Examples include *basis arbitrage* (such as to take advantage of possible differences between the price of the spot EUA contract and the price of the future EUA contract minus its cost of carry), *inter-market spread* contracts (where participants take simultaneous positions in two or more related contracts such as UK natural gas, UK power and EU emissions in order to hedge potential spread risks among contracts), *repo* contracts (where an investment banks buys emissions contracts from a seller to monetize the allowances up front and then sells back the emissions to the original counterparty at an agreed future date and price reflecting differences between the implied emissions market and financial market costs of carry), and *swap* contracts (to reflect the difference price and risk characteristics of EUA and CER). Investment banks like Merrill Lynch are also succeeding in attracting new participants to the carbon market by deriving synergy from their wealth management businesses. Increasingly individual investors wish to have some exposure to the carbon market. This can be accomplished by designing structured emission products (using put or call options to create an investment note that provides an agreed level of principal protection and capital participation) based on underlying EUA or CER futures contracts.

Question: Is it possible to have strong and efficient forward markets with restrictions on the use of permits, such as limited banking and borrowing?

Linkage between Australia's ETS and the global carbon markets will promote a strong and efficient forward market. A globally carbon market that links national or regional cap and trade schemes is a desirable policy objective since it will establish one carbon price and ensure that companies focus first on the lower emission abatement cost opportunities. From a financial perspective, more liquidity with a smaller set of different carbon emission commodities instead of less liquidity with a larger set of different carbon emission commodities means that the markets will perform in a more efficient manner. In some cases, emerging carbon markets that are unlinked to the broader carbon markets may fail to attract market intermediaries if the perceived liquidity is too low. For example, the pilot voluntary UK Emission Trading Scheme that predated the mandatory EU ETS was a worthy effort to encourage UK companies to undertake early projects to reduce emissions but was an illiquid market. Bid-offer spreads were wide since trading volume was extremely low.

If a decision is taken not to link via allowances, indirect linkage between schemes is also possible via Kyoto-compliant carbon credits (based on the CDM) and should be strongly encouraged. Australia should not establish its own rulebook for what constitutes an eligible project-based carbon credit since this would increase transaction costs considerably and would unnecessarily duplicate the extensive efforts being taken by the United Nations through the CDM.

Banking should be unlimited both within and between phases. This rewards companies who take actions to reduce emissions in the earliest part of the scheme.

Borrowing between phases should not be permitted since it can distort market signals. Borrowing within a phase is readily available, on commercial terms, through the flexibility to buy additional allowances today from a financial intermediary in return for committing to sell back those allowances at a future point in time.

Additional Observations: The Australian and global financial services sector has a crucial part to play in the solution to climate change by mobilising capital flows and are best placed to offer practical insights on how to ensure that the carbon markets can function in as efficient a manner as possible. Some additional recommendations to promote the health of the carbon markets and to remove barriers to carbon finance include:

- Include explicit short-, medium, and long-term quantitative emission reduction targets in the Australian ETS as well as in future climate change agreements to provide the necessary long-term signal to the market about the unambiguous direction of future climate change policy.
- Ensure that the Australian carbon markets is at least indirectly linked to the global carbon market via common acceptance of the Kyoto-compliant carbon credits and provisions that allow companies to import international carbon credits to meet their domestic compliance obligations.
- Work towards a gradually more integrated global carbon market by ensuring that new national cap and trade schemes do not include price controls, recognise existing carbon instruments from other cap and trade schemes, and include banking and borrowing provisions broadly in line with existing schemes.
- Dismantle trade barriers that restrict diffusion of low-carbon technologies so as to encourage investment and business participation.
- Manage the intellectual property rights regime to balance the need to provide incentives for innovation in new low-carbon technologies and the dissemination of existing low-carbon technologies to developing countries.
- Influence public behaviour and acceptance of all low-carbon technologies through awareness raising and education about their contribution to combating climate change to help ensure uptake and future demand. This is of particular relevance for technologies such as nuclear power that will face significant local opposition that could delay or even limit their implementation.